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Customer Management

SUNIL GUPTA

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Sunil Gupta, Edward W. Carter Professor of Business Administration, Harvard Business School, developed this Core Reading with the assistance of Joseph Davin, DBA candidate, Harvard Business School.

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1 INTRODUCTION

Customers are critical for an organization's survival, providing it with top-line revenue. That is why customer service typically focuses on satisfaction: Delight customers and you will attract and retain their business; treat them wrong and you will lose them. In this reading, however, we will explore why organizations need to do more than simply satisfy customers. Rather, they need to manage their customer relationships carefully and ask themselves hard questions. For example, how much customer satisfaction is enough? Certainly, you could aim to maximize customer satisfaction continually, but this comes at a cost. Should you aim to please everyone? How should a manager choose from various growth levers in order to expand the business?

Indeed, the metric used to determine success could make or break a company. In a classic example from the early 1990s, the United Kingdom division of Hoover, a company well-known for its vacuum cleaners, offered a promotion to increase its sales and improve its market share. In the summer of 1992, Hoover UK announced a promotion where any consumer who bought £100 worth of Hoover products would be rewarded with a pair of free airline tickets between the United Kingdom and Europe. When the initial phase of the promotion got enthusiastic response from consumers, the company decided to sweeten the deal. This new deal, offered in the winter of 1992, would give free airline tickets between the United Kingdom and the United States to consumers who bought £250 worth of Hoover products. The campaign proved wildly successful in generating additional sales and helped Hoover acquire many new customers. Although Hoover delighted its new customers and gained substantial market share, the promotion decimated Hoover's profits, causing the company to take a charge of almost £50 million against its earnings. And the top executives of the UK division were fired.¹

Clearly, then, it isn't difficult to increase sales or grow market share by dropping prices or by offering attractive incentives to consumers. That is why the goal of customer management is to grow the business *profitably* by acquiring, retaining, and developing the *right* customers. Customer management allows marketing managers to drill down into each customer's profitability or lifetime value to inform the organization's investment decisions.

This reading sheds light on how companies should evaluate and manage their customers in order to grow profitably. We begin by looking at what we think of as the two sides of customer value, as well as the concept of customer lifetime value (CLV). From there we delve into how organizations make decisions using CLV and how they calculate it. We then explore the ways that organizations acquire,

retain, and develop customers, and conclude with a discussion of customer equity and the implications for organizational structure before moving into the Supplemental Reading.

2 ESSENTIAL READING

2.1 Two Sides of Customer Value

Customer value is a two-way street. Marketing managers typically focus on one side of that street: providing a great customer experience by delivering superior value to their customers.² For them, the customer is king and everything must be done to delight a customer. It is important, however, to balance this view with the other side of customer value, where customers provide value to the firm by bringing in profits. In its zeal to grow sales, Hoover UK ignored the long-term profitability of the company. In essence, it focused on providing value *to* customers but ignored the value it could get *from* customers. The real challenge for a manager is to strike a balance between these two sides of customer value (**Exhibit 1**).

EXHIBIT 1 Two Sides of Customer Value



Source: Gupta, Sunil; Lehmann, Donald, *Managing Customers as Investments: The Strategic Value of Customers in the Long Run* (Paperback), 1st, © 2005. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

A company's customers can be mapped to one of the four quadrants in Exhibit 1 to help show which customers are worth keeping on both dimensions. *Star customers* receive high value from and deliver high value to the company. They are the most desirable—loyal, satisfied customers who deliver long-term profits. In effect, the company does not need to change very much to manage these customers further.

On the other extreme, customers in the *lost causes* quadrant do not value the company's goods and services and are not very profitable either. They may cost the company more than they are worth because they frequently complain or return products, spread bad word-of-mouth news, or lower morale by badgering staff members. If it does not make economic sense to invest the time and effort to nudge customers in this quadrant into another quadrant, the company should be careful not to acquire them in the first place. If the company already has such customers, it should consider letting them go. While it might sound strange to let customers go and lose market share, in such cases, reduced market share may actually lead to improved company performance. Getting more customers is not always good if they are the wrong kind. One study found that almost 80% of customers at a bank were unprofitable; the cost to serve them was literally more than they were worth.³

Not everyone falls into one of these two extremes. In the lower right quadrant of Exhibit 1 are *free rider* customers, who are highly satisfied with the company but are not highly profitable. The Hoover UK customers fell into this category; the company was providing customers with goods and services beyond what they were paying for.

How can organizations improve the profitability of these customers? For one thing, they can charge higher prices to get more value from them. Or they can reduce their service to these customers because service costs money. Notice once again we are going against conventional wisdom, asserting that it is not good to delight all customers. Those who are less valuable to the company do not deserve all the benefits.

In the upper left quadrant of Exhibit 1 we have *vulnerable customers*, customers who are highly valuable to the company but do not receive a lot of value in return. These customers are important to company profitability, yet they can be poached by competitors. They might stay with the company for a short period if they lack alternatives or hope to avoid high switching costs, but a smart competitor could identify them and attract them away. This was what happened at US Airways. In 1993, it had 41% market share of nonstop flights out of the Baltimore-Washington airport. Even though customers paid high prices for poor service, they were held captive, because the airline had a virtual monopoly at the airport. When Southwest Airlines entered this market, it stole vulnerable

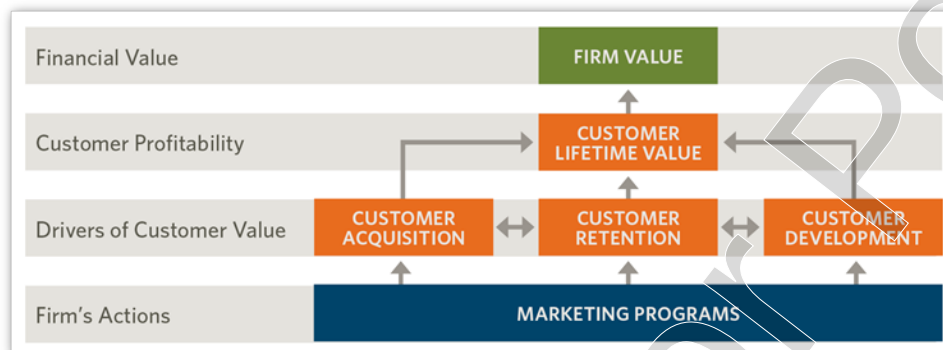
customers from US Airways and, by 2010, US Airways' market share shrank to 6%.⁴

That is why the two-sided customer value framework is so useful. It considers both angles rather than using traditional marketing metrics like market share and customer satisfaction, which consider only one side of customer value. A company with a large market share whose customers lie mainly in the free rider quadrant is vulnerable. In early 2000, many insurance companies realized this the hard way, when they were saddled with claims from customers in hurricane-prone areas in the United States.

Besides offering a metric that considers both sides of customer value, the framework also challenges the notion that a company should provide the same level of excellent service to all customers. Service requires company resources; free riders are already getting too much value while vulnerable customers are not getting enough. Therefore, organizations should consider moving resources away from free riders and allocating them to vulnerable customers instead—but first they need to determine how many customers fall into each quadrant. Most companies report share or profit by business unit or geographic area, so they have no idea about the mix of customers in their own portfolio and may well miss a key opportunity to improve profitability.

How, then, can organizations manage customers effectively? A concept called **customer lifetime value (CLV)** is a good place to start. CLV takes into account both the value organizations get from customers and the value they give to customers. For the rest of this reading, we will follow the framework outlined in **Exhibit 2** to discuss customer management using CLV. Simply put, if the goal of customer management is to increase overall firm value, and customers are the source of profits, then customer lifetime value feeds into the firm's value. Organizations can aggregate CLV across current and future customers to determine their **customer equity**, which provides a proxy for firm value. To illustrate, we will draw on research and industry examples that use customer equity to estimate company value.

EXHIBIT 2 Framework Linking Marketing Actions to Customer Lifetime Value and Company Value



Source: Gupta, Sunil; Lehmann, Donald, *Managing Customers as Investments: The Strategic Value of Customers in the Long Run* (Paperback), 1st, © 2005. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

Organizations can use CLV to distinguish high-value customers from low-value customers and to focus marketing programs to affect three drivers of CLV: customer acquisition, customer retention, and customer development. Later in this reading, we will describe the key questions needed to build a strategy for each driver and describe how managers might answer those questions. First, however, let's look at CLV in more depth.

2.2 Customer Lifetime Value

What exactly is customer lifetime value? How do organizations use it to inform marketing decisions? In this section we will answer those questions and look at how to calculate customer lifetime value (CLV). We will end by examining some of the challenges and limitations of CLV.

At its core, CLV is the present value of all future streams of profits that an individual customer generates over the life of his or her business with the firm. Note two important details regarding that definition. First, CLV is based on *profits*, not revenue; specifically, it is based on *contribution*—which is revenue less direct and attributable costs. Metrics such as market share consider volume or revenue but ignore the costs involved in serving a customer. Offering low prices or attractive deals may increase sales but could hurt profitability. Customers who are costly to serve may be less profitable, even if they provide more revenue.

Second, CLV is a measure of a customer's *profitability over the long term* and is therefore defined over the lifetime of a customer. It explicitly considers the possibility that customers may leave the company because of either poor service

or more attractive offers from competitors. Organizations therefore typically use a three- to five-year time horizon to evaluate customers' long-term profitability.

2.2.1 Using CLV to Make Decisions

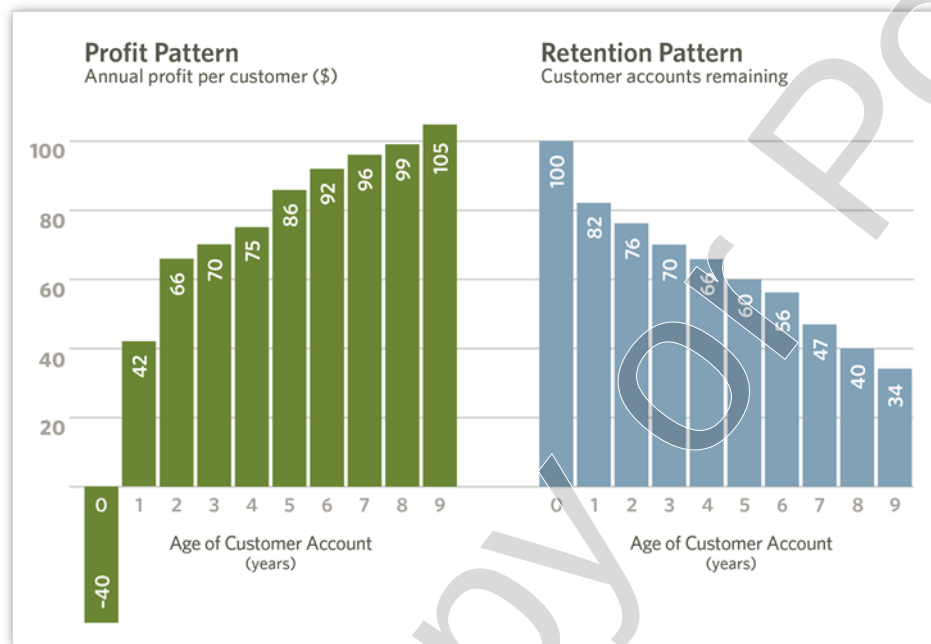
Organizations can enlist CLV to help make a wide range of strategy and managerial decisions, for example:

- Because CLV is the benefit that an organization derives from a customer over his or her life, it can be used to establish customer acquisition cost limits.
- CLV provides a way for an organization to segment its customer base—from high-profitability to low-profitability customers. Knowing each customer's profitability is the first step to managing all of them.
- A customer's lifetime value is not static. An organization can improve its customers' CLV by understanding the factors that drive CLV and finding ways to influence those drivers. For example, increasing customer retention has a major impact on CLV because customers stay longer and provide more profit for the firm.
- CLV helps managers make investment decisions. For example, a marketing manager may want to improve customer satisfaction but may find it hard to justify how much to invest in this endeavor. But if the manager can link customer satisfaction to retention rate and subsequently CLV, the task becomes easier.
- In addition to guiding customer management decisions, CLV provides an estimate of a firm's value. Most companies derive the bulk of their profits from customers, which suggests that the value of current and future customers should provide a proxy of a firm's market value. For subscriber-based companies such as Netflix, Sirius satellite radio, credit card companies, and others, financial analysts often carefully examine CLV drivers to assess the health of these businesses. In a subsequent section of this reading, we present sample customer-equity calculations.

2.2.2 Calculating CLV

Now that we have clarified the importance of CLV, we can determine how to calculate it. To estimate CLV, a firm needs to track two pieces of information—annual profit per customer and the customer retention pattern. **Exhibit 3** shows the profit and retention pattern of the customers of a credit card company.

EXHIBIT 3 Profit and Retention Patterns for the Customers of a Credit Card Company



Source: Adapted and reprinted from *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value*, by Frederick F. Reichheld and Thomas Teal. Harvard Business Review Press. Boston, MA: 1996, p. 57. Copyright © 1996 by the Harvard Business School Publishing Corporation; all rights reserved.

In this example, the credit card company, like many of its competitors, sent direct mail and other promotional materials to acquire customers. Most of these mailings went in the trash and the response rate was 1%. The effective cost to acquire one customer in year 0 for this company was \$40 (each mailing cost \$0.40, and it required 100 mailings, on average, to gain one customer). In our example, the firm acquired 100 customers in year 0 at a cost of \$40 each, for a total investment of \$4,000.

Once these customers were acquired, they started using their cards and generating profits for the firm. By tracking the **cohort** of the original 100 customers, the firm discovered that 18 of the customers defected in the first year, leaving the firm with 82 customer accounts.^a Each of the remaining 82 customers provided the firm, on average, a profit of \$42 in the first year. By the end of the second year, another six customers defected, leaving the firm with 76 customers, each providing an average profit of \$66. Thus, as the right side of Exhibit 3 shows, the cumulative retention probability of an average customer was 0.82 (82%) in

^a CLV is an individual-customer-level concept, and ideally firms should assess the profitability and retention rate of each individual customer. However, many companies find it easier to apply it to a cohort of customers, as illustrated in this example.

year 1, 0.76 in year 2, and so on. Exhibit 3 shows the effect of the cumulative retention probabilities for the original 100 customer accounts.

Assuming a 10% annual discount rate, the CLV of a customer in this cohort can be calculated as follows:

$$CLV = \frac{\$42 \cdot 0.82}{(1+0.1)} + \frac{\$66 \cdot 0.76}{(1+0.1)^2} + \dots$$

The first term in the equation is the present value (PV) of profit generated by the average customer in year 1, the second term is the present value of the profit from the average customer generated in year 2, and so on. **Exhibit 4** shows detailed calculations for a typical customer in this cohort. The third column (annual retention probability) shows the probability that a customer was retained that year. The fourth column (customer accounts remaining) shows the cumulative effect of those probabilities on the original 100 customer accounts. Because the nine-year horizon CLV of a customer from this cohort is \$261, which is significantly higher than the acquisition cost of \$40, these customers are a good investment for the organization.

EXHIBIT 4 Calculating CLV for a Credit Card Company

Year	Profit per Customer (\$)	Annual Retention Probability	Customer Accounts Remaining	Annual Discount Rate	Cumulative Discount Factor	Discounted Cash Flow (\$)*
0			100			
1	\$42	82%	82	0.10	0.91	\$31
2	66	93%	76	0.10	0.83	41
3	70	92%	70	0.10	0.75	37
4	75	94%	66	0.10	0.68	34
5	86	91%	60	0.10	0.62	32
6	92	93%	56	0.10	0.56	29
7	96	84%	47	0.10	0.51	23
8	99	85%	40	0.10	0.47	18
9	105	85%	34	0.10	0.42	15
Total	—		—		—	\$261

*Numbers may not sum due to rounding.

EQUATION 1 Customer Lifetime Value (CLV)

In general, CLV for a customer can be written as:^b

$$CLV = \sum_t \frac{m_t r_t}{(1+i)^t}$$

where

m_t = profit or contribution margin during year t

r_t = retention probability during year t

i = constant discount rate

t = year

Equation 1 captures several key aspects of customer profitability: the current as well as future revenue potential of the customer, the cost of providing goods and services, the time value of money, and the uncertainty associated with future cash flows should a customer stop doing business with the organization.

The concept of CLV is analogous to **discounted cash flow** in finance, with two major differences. First, CLV is calculated at the individual customer level, not at the aggregate level, because profitability and retention probability vary by customer. Second, we account for the possibility that customers stop doing business with the company by defecting to a competitor or getting out of the market.

We can simplify the CLV calculations by assuming that (1) customers have a constant profit margin m over time, (2) customers have a constant rate of retention r over time,^c (3) the discount rate is constant over time, and (4) value is estimated over an infinite horizon. These assumptions are reasonable under most scenarios and can be easily modified. Under these assumptions,⁵ CLV simplifies to **Equation 2**:^d

^b It is also common to define *net* CLV after deducing the acquisition cost from this equation.

^c See Sunil Gupta and Donald R. Lehmann, *Managing Customers as Investments: The Strategic Value of Customers in the Long Run* (Upper Saddle River, NJ: Pearson Education, Inc., 2005) for more discussion about these assumptions. Note also that, even if retention rates are constant at an individual level, the aggregate retention rate for a cohort of customers may increase over time. This can happen when customers with low retention rates leave the cohort while those with high retention rates stay, which makes the average retention rate of remaining customers higher than before. For more information, see Peter S. Fader and Bruce G. S. Hardie, "Customer-Base Valuation in a Contractual Setting: The Perils of Ignoring Heterogeneity," *Marketing Science* 29 (2010): 85–93.

^d This is the sum of a geometric series.

EQUATION 2 Simplified Customer Lifetime Value (CLV)

$$CLV = m \cdot \left(\frac{r}{1+i-r} \right)$$

In this equation, we call the term $\frac{r}{1+i-r}$ the *margin multiple*.

CLV for a customer is the annual profit margin that a customer provides to the firm multiplied by the margin multiple. The margin multiple depends on two components: the retention probability and the discount rate. If the customer has a high probability of staying with the company, then he or she is expected to have a longer lifetime with the company and therefore a higher lifetime value. If the discount rate is high, then future cash flows amount to less and thus reduce the total lifetime value of a customer.

For example, consider a prepaid wireless customer in the telecom industry. In 2012, the annual retention rate in this industry was 90%, and the discount rate based on **weighted average cost of capital** was 11%. Using Equation 2, the margin multiple is

$$\frac{0.90}{1 + 0.11 - 0.90} = 4.29$$

Using the average monthly revenues in this industry of \$53, and the cost to serve of \$13, we estimate monthly profits of a typical customer as \$40 and annual profits as \$480. Therefore, CLV of a customer can be estimated as $\$480 \cdot 4.29 = \$2,059$.

Based on typical retention and discount rates across a number of industries, the margin multiple is between 1 and 4.5 (**Exhibit 5**). This suggests that if the annual profit from a customer is \$100, the customer's lifetime value is between \$100 and \$450, depending on his or her retention rate and the firm's discount rate.

EXHIBIT 5 Margin Multiple

$\frac{r}{1+i-r}$				
Retention Rate r	Discount Rate i			
	10%	12%	14%	16%
60%	1.20	1.15	1.11	1.07
70%	1.75	1.67	1.59	1.52
80%	2.67	2.50	2.35	2.22
90%	4.50	4.09	3.75	3.46

Source: Gupta, Sunil; Lehmann, Donald, *Managing Customers as Investments: The Strategic Value of Customers in the Long Run* (Paperback), 1st, © 2005. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

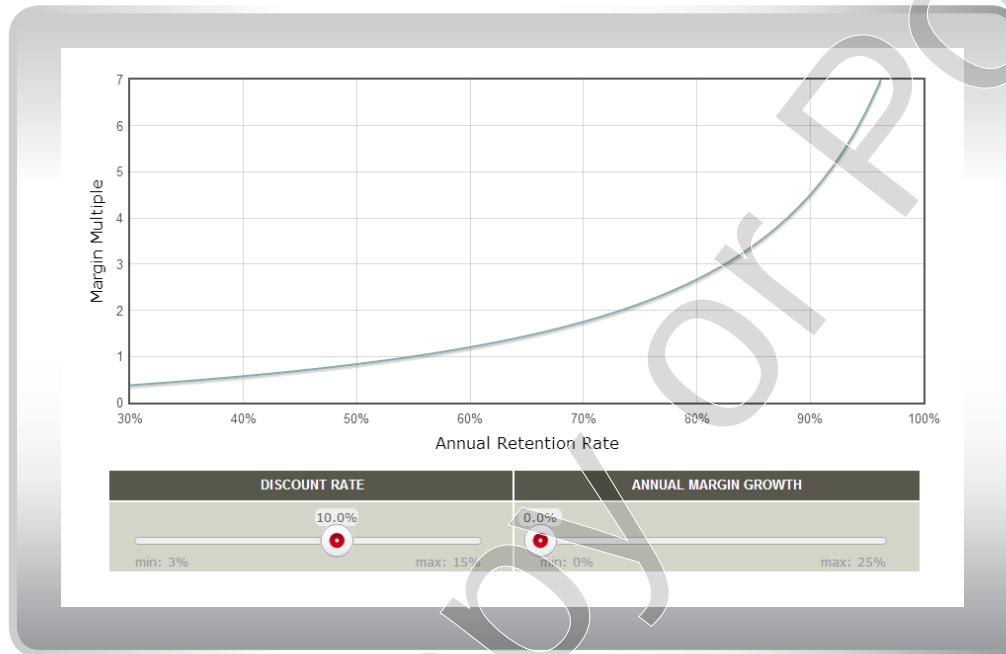
Interactive Illustration 1 calculates margin multiple as a function of retention rate and discount rate. Notice that, as you change the discount rate, the margin multiple changes at every retention rate. In addition, the slope of the line is continually increasing. For that reason, incremental increases in customer retention rate when the rate is already high (on the right side of the graph) have a bigger impact than incremental increases in retention rates at lower retention rates (left side of the graph). For example, if a company can increase its customer retention rate from 80% to 85%, it will always have a bigger impact on the margin multiple than if the company increased its customer retention rate from 50% to 55%. This effect is even more pronounced when there is positive growth in customer margin over time.



INTERACTIVE ILLUSTRATION 1 Margin Multiple



Scan this QR code, click the image, or use this link to access the interactive illustration: bit.ly/hbsp2DYKIZL



Using the margin multiple, CLV can be estimated without a spreadsheet. For example, if the discount rate is 12% and the retention rate is 90%, the margin multiple is about 4. When $m = \$100$, CLV is approximately \$400. Such back-of-the-envelope calculations can quickly rule out some investment decisions. The margin multiple provides a sense of the order of magnitude of CLV relative to acquisition cost.

Remember that CLV is calculated at the individual level. So a customer who has an 80% retention rate is worth more than twice as much as another customer with a 60% retention rate. (Compare the margin multiples in Exhibit 5.)

An example calculation illustrates how this works in practice. Consider an organization with a discount rate of 12%, whose 10 million customers have an average retention rate of 80% and an annual contribution margin of \$100. A customer satisfaction program can enhance retention rates from 80% to 90% in a year. Using the margin multiple table in Exhibit 5, calculate how much the manager can invest in this satisfaction program.

Interactive Illustration 2 provides another way to calculate CLV. The acquisition cost (in year 0) is the direct marketing cost for all customers, even those who do not respond. Thus, it is calculated as the direct marketing cost divided by the acquisition response rate. On the other hand, mailing costs are incurred every year only for retained customers. As usual, we apply a discount

rate to the customer contribution to get a present value (PV). As you can see, in CLV, we also apply a retention rate to get the present value of each year's customer contribution. The CLV is the sum of those present values.

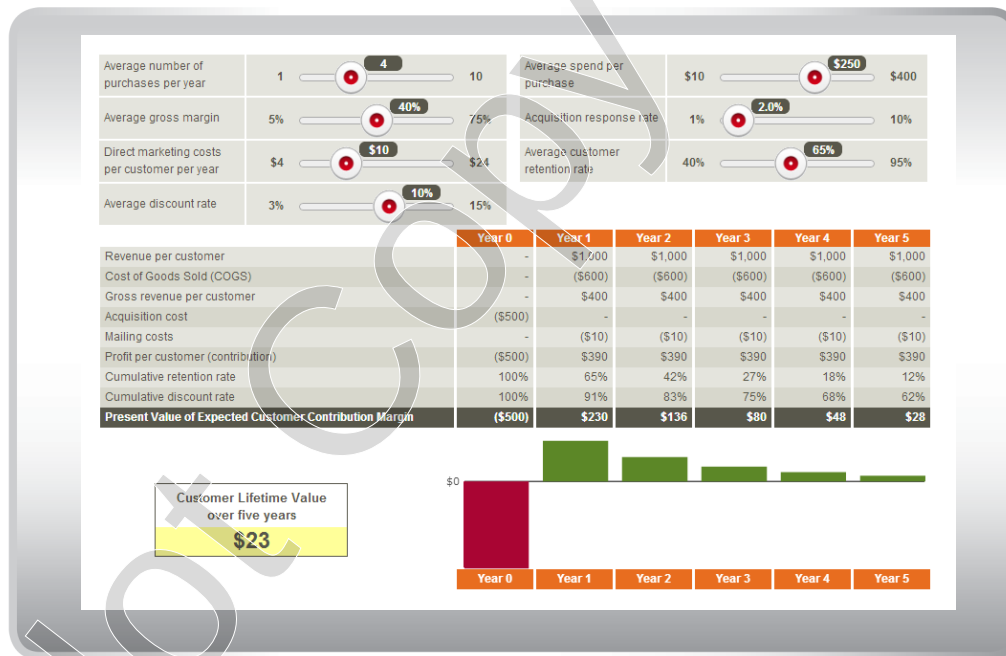
When using Interactive Illustration 2 to address the customer satisfaction program question above, be aware that some seemingly relevant costs may not be relevant to the value of the program. Does the acquisition cost of the customers matter when evaluating the customer satisfaction program? What about the direct marketing costs? Only one cost matters in this scenario; make sure you understand which one and why. (*Hint: A margin of \$100 is equivalent to average spending of \$200 times one purchase per year times 50% gross margin.*)



INTERACTIVE ILLUSTRATION 2 Customer Lifetime Value (CLV) Calculator



Scan this QR code, click the image, or use this link to access the interactive illustration: bit.ly/hbsp2pl1nam



2.2.3 Challenges, Extensions, and Limitations of CLV

The information needed to calculate CLV is not always easy to access. For example, an organization's top-line revenue sometimes cannot be broken down and attributed to individual customers. In a restaurant or retail setting, for instance, customers are often anonymous, making a CLV calculation impossible. Loyalty cards and customer identifiers such as telephone numbers can be used to match transactions with customers. Even if an organization can link revenue with specific customers, it must then drill down into direct or attributable costs in order to calculate profit (the customer's contribution). Although activity-based costing is a way to derive a cost figure per customer, such a project can be an

arduous task for companies because it requires cooperation across different departments in the organization. Forecasting each customer's retention probability requires analysts who can build sophisticated statistical models.

Ideally, managers should calculate CLV at the individual customer level. However, without individual-level data, CLV can be calculated at the customer-segment level or at the aggregate level as a starting point. For example, a company serving small and medium businesses might want to segment companies by size for purposes of calculating CLV.

Beyond the challenges to calculating CLV, the formula can be extended to accommodate revenue growth. If the annual contribution margin for a customer grows at the rate of $g\%$ per year and m is the contribution in the first year, then the formula for CLV becomes:

$$CLV = m \cdot \left(\frac{r}{1 + i - r(1 + g)} \right)$$

Note, however, that CLV is not the final word on the value of a customer. Along with a quantitative view of customers using CLV, managers should be aware of the strategic and qualitative aspects of customer management. Customers who do not appear attractive according to CLV calculations may actually be very important strategically for the company. For example, software companies launching a new product may target a small segment of unprofitable early adopters with a beta version for debugging and feedback to develop a more stable end product for mainstream audiences later. Another example might be a new company that gives deep discounts to win contracts in a business-to-business context because it helps develop their reputation and brand equity. These strategic considerations are very important and should not be dismissed; they should be carefully weighed against the measurable quantitative aspects of customers.

Next we will look at three drivers of CLV—customer acquisition, customer retention, and customer development—and how managers might answer the key questions needed to build a strategy for each driver.

2.3 Customer Acquisition

Charlie O'Donnell of First Round Capital described the importance of customer acquisition for a startup:

If you're not focused on how you're going to acquire your customers—and more importantly at what cost—then it's going to be very hard to build a business, and even harder for us

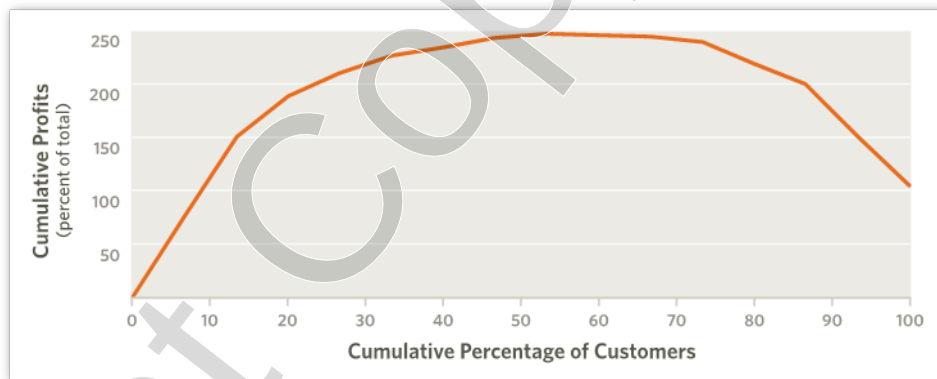
[venture capitalists] to assess whether or not you even have a business.⁶

Customer acquisition also needs to keep pace with customer defection just to maintain the same number of customers. People switch phone companies, cancel credit cards, and buy different brands of detergent and yogurt all the time. So organizations continually need new customers to grow the business. In this section, we will look at the kinds of customers that organizations should acquire and ways to acquire them.

2.3.1 Which Customers Should an Organization Acquire?

In his famous book *Animal Farm*, George Orwell wrote, “All animals are equal, but some animals are more equal than others.”⁷ Although Orwell’s novel was a work of satire, we intend no irony in saying, when it comes to customer management, all customers are important, but some are more important than others.

EXHIBIT 6 Whale Curve for an Electronics Parts Company



Source: Adapted and reprinted from Harvard Business School, “Kanthal (A),” HBS No. 190-002, by Robert S. Kaplan. Copyright © 1989 by the President and Fellows of Harvard College; all rights reserved.

The Pareto principle, also known as the 80–20 rule, would suggest that 20% of customers provide 80% of an organization’s revenue. But today’s customer management realities might be better described as a 200–20 rule, where 20% of the customers provide 200% of the firm’s profits. **Exhibit 6** shows a typical *whale curve* of an electronics components manufacturer. Customers are ranked according to their profitability on the horizontal axis, while the vertical axis indicates cumulative profits that these customers generated. According to these figures, the first 20% of customers generate approximately 200% of company profits. Only the top 50% of the customers are profitable. The company either breaks even or generates a loss from the remaining customers. Unless the firm

can improve these customers' profitability, perhaps it is not worth acquiring such customers in the future.

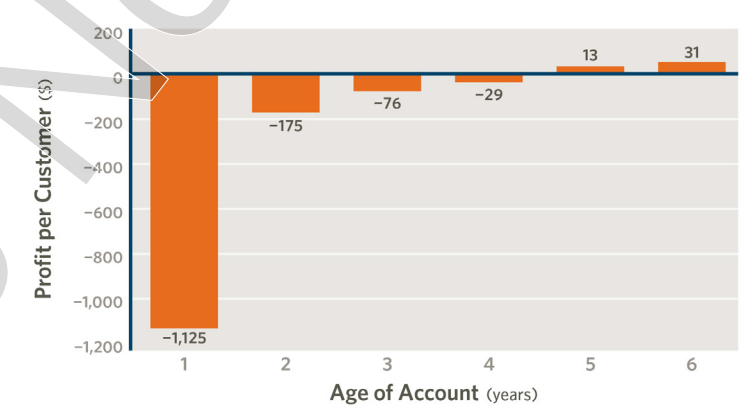
An insurance company realized this truth when it saw the profit pattern of its typical customers (see **Exhibit 7**). Formerly, the company employed independent agents who were paid a commission for each newly acquired customer. Because agents' commissions were paid up front and the firm generated revenue from the insurance premiums that customers paid over the years, a customer did not become profitable until after seven to ten years. The implications were clear—the firm should not acquire customers who stay less than seven to ten years with the firm. The company's internal analysis also suggested that customers who were acquired via the agents' listings in the Yellow Pages telephone book were far less loyal than those who were acquired through word of mouth. The company therefore instructed agents to halt Yellow Pages advertising because it attracted the wrong types of customers. It also changed the agents' pay structure to reward them for better-quality customers who stayed with the firm longer.⁸

More and more companies are realizing that not all customers are valuable. A November 2004 *Wall Street Journal* story carried the headline "Best Buy Decides Not All Are Welcome." Bargain hunters who cost a lot for returns and other services were draining Best Buy's profitability.⁹ Wireless carrier Sprint cancelled contracts with customers who were costly to serve because they called customer service excessively.¹⁰ In fact, a survey found that 85% of executives had divested customers from their portfolio.¹¹ And yet firing customers should be done cautiously; such actions could hurt a company's brand and its public relations.

2.3.2 How Organizations Acquire Customers

Companies can employ five broad strategies to acquire customers effectively:¹²

EXHIBIT 7 Customer Profit over Time for an Insurance Company



Source: Adapted and reprinted from *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value*, by Frederick F. Reichheld and Thomas Teal. Harvard Business Review Press. Boston, MA: 1996, p. 57. Copyright © 1996 by the Harvard Business School Publishing Corporation; all rights reserved.

- 1 *Increase market size.* Companies routinely expand their product space or enter new markets to acquire customers. Apple ventured into the consumer electronic space with the iPod and iPad and acquired non-Mac users in the process. Many fashion houses tap into the middle market segment by extending their brand. Firms also can acquire customers in emerging markets with a growing middle class, such as in India, China, and Brazil.
- 2 *Increase marketing investment.* The company can acquire new customers by increasing marketing expenditure to create awareness, generate trial, or convert nonbuyers into regular customers. For example, banks spend significant marketing dollars in online ads to attract new checking account and credit card customers—worthwhile spending as long as customer acquisition costs are less than the expected lifetime value.
- 3 *Increase effectiveness of acquisition programs.* Instead of spending more, an organization can increase the effectiveness of its acquisition programs by identifying more responsive, higher-value customers or by using more effective communication tools to reach prospects. For example, online channels are generally most cost-effective for acquiring customers for financial service products.
- 4 *Offer discounts and incentives.* Organizations commonly offer short-term incentives and discounts to entice customers, such as the coupons and sales at supermarkets and department stores. Retail stores draw a huge crowd on Black Friday (the day after Thanksgiving in the United States) by offering deeply discounted products. But this approach isn't always profitable because consumers tend to defect when prices return to regular levels. Further, discounts attract price-sensitive customers who put a downward pressure on margins.
- 5 *Generate positive word of mouth.* In general, consumers trust their friends far more than they trust advertising. Therefore, the most effective way to acquire new customers is to delight current customers. A study compared traditional marketing efforts (broadcast media and direct mail) with referrals and found word of mouth far more profitable in the long term.¹³

2.4 Customer Retention

Once organizations acquire customers, they then need to worry about keeping them. Customer retention rates, or the percentage of customers who stay with a company in a given period (e.g., a year), provide one measure of customers' satisfaction and loyalty. Some companies report **customer churn rate** (synonymous with the terms *customer defection* and *customer attrition rate*), which is defined as 100% minus the customer retention rate. Both retention and churn rates are defined on a monthly, quarterly, or annual basis. Retention rates are also directly linked to the expected lifetime of a customer. For example, if the annual retention rate is 50%, the average customer lifetime is two years. In general,

$$\text{Expected Customer Lifetime} = \frac{100\%}{100\% - r}$$

where r = retention rate, in percent.^e

Interactive Illustration 3 calculates expected customer lifetime as a function of retention rate. Try these steps:

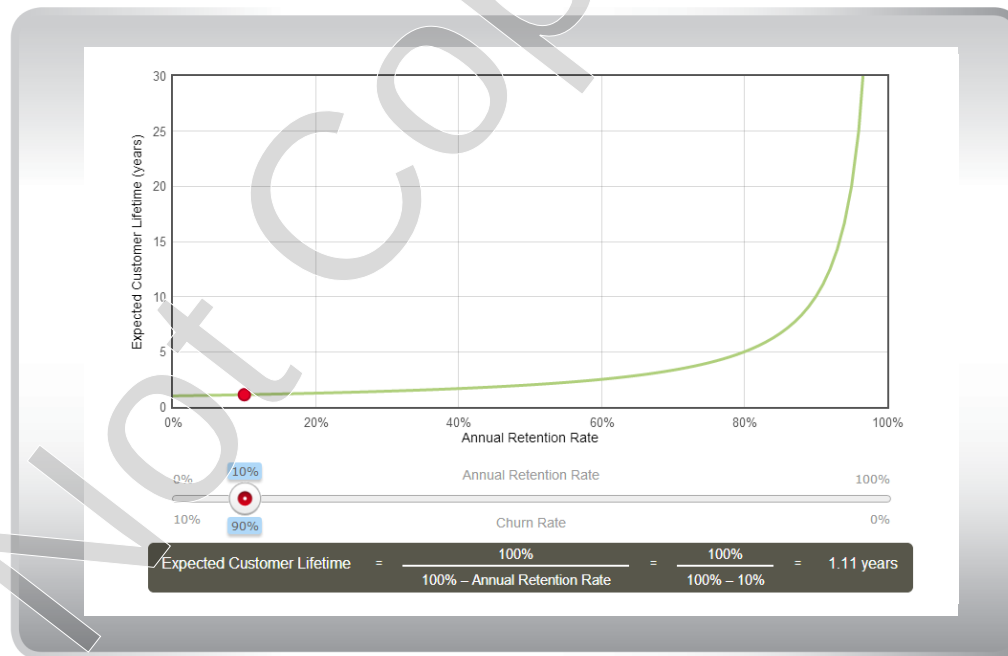
- 1 Set retention rate to 20%. What is the expected customer lifetime? The formula to calculate expected customer lifetime applies the retention rate to customers at the end of each year. Thus, the expected lifetime of customers with a retention rate of 0% is one year.
- 2 What if the retention rate is 80%?
- 3 Shift the retention rate from 40% to 45%. What is the increase in expected customer lifetime?
- 4 Now try shifting the retention rate from 90% to 95%. How does the result differ from the result in step 3?



INTERACTIVE ILLUSTRATION 3 Expected Customer Lifetime

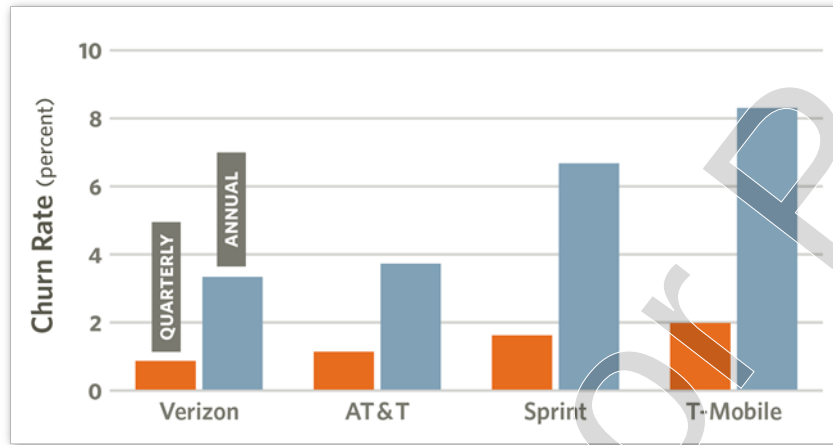


Scan this QR code, click the image, or use this link to access the interactive illustration: bit.ly/hbsp2ukWBnX



^e It is a common yet incorrect practice in industry to multiply margin by expected customer lifetime, but this will significantly overestimate CLV.

EXHIBIT 8 Churn Rate in the US Wireless Industry (Quarter 2 in 2012)



Source: Phonearena, "Verizon Reports Lowest Churn Rate in the Industry for Q2," http://www.phonearena.com/news/Verizon-reports-lowest-churn-rate-in-the-industry-for-Q2_id33174, accessed March 2013.

There is no typical retention rate in marketing. Retention and churn rates can vary dramatically by industry and by company within an industry. For example, in the second quarter of 2012, T-Mobile's churn rate was more than 2.5 times that of Verizon (**Exhibit 8**). In financial services, churn rates for checking accounts are much lower than credit card churn rates, which can be as high as 30% per year.

Churn rates also need not exhibit the same relationship across countries. Culture and competition within the industry affect norms around customer defection. The churn rates of the Internet and mobile phone industries in Europe are about two to four times that of the European credit card industry, while the reverse pattern is true for the United States. The US credit card industry churn rate is almost twice the churn rate of the mobile phone industry (see **Exhibit 9**).

EXHIBIT 9 Churn Rates by Industry and Country

Percentage of Customers that Switched Providers in the Past Year						
	Italy	France	Spain	Germany	United States	United Kingdom
Supermarket	36%	34%	32%	27%	32%	27%
Internet	25	22	29	29	38	24
Mobile phone	22	21	23	21	11	38
Bank	20	16	23	16	25	18
Car or home insurance	17	16	21	16	12	25
Credit card	6	7	9	7	20	16
Travel agent	12	7	14	6	3	8
Utility provider	1	1	1	6	12	17

Source: Tom Boobier, "Keeping the Customer Satisfied: The Dynamics of Customer Defection, and the Changing Role of the Loss Adjuster," CILA report, <http://www.cila.co.uk/publication/articles/keeping-customer-satisfied-tony-boobier>, accessed March 2013.

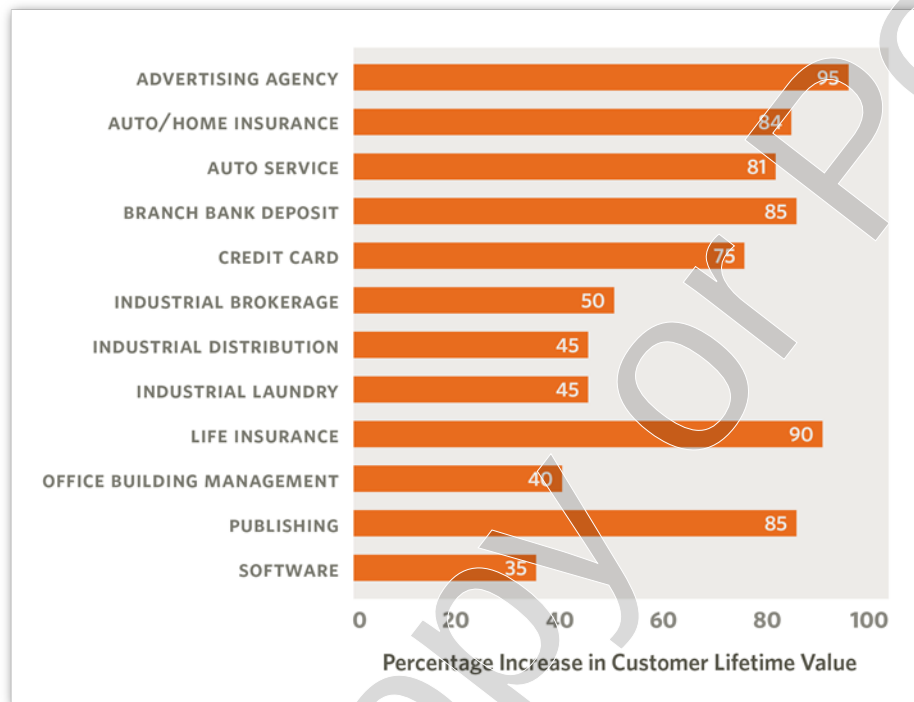
In contractual settings, such as cell phone plans and gym memberships, it is easy to determine customer churn rate, because a customer has to cancel a contract in order to end the relationship with the company. In non-contractual settings, however, such as customers who buy books from Amazon or clothes from L.L.Bean, it is much harder to know churn rates. For example, if a customer does not buy books from Amazon for six months, has she defected to a competitor or is it simply a short-term hiatus in her purchase cycle? Researchers have developed statistical models to infer when a long hiatus in purchase may be an indication of customer defection. But many firms use a simple rule of thumb to define customer defection. For L.L.Bean, churn occurs if a customer stops purchasing its products for 12 months.

2.4.1 Why Retain Customers—and How?

Customer retention rate is critical for the long-run health of a company. If a company has a 70% retention rate, it loses almost one-third of its customer base every year. Put differently, the firm has to undertake the costly acquisition of its entire customer base almost every three years.

An analyst has described retention as "the single most important metric" for determining the value of cloud computing companies because customer retention is the main driver of CLV.¹⁴ When the retention rate improves from 50% to 67%, the average customer lifetime grows from 2 to 3 years. (You can verify this using Interactive Illustration 3.) A small increase in retention rate can result in large increases in expected lifetime and CLV. One study estimated that a 5% reduction in churn could increase customer lifetime value by 35% to 95% across a number of industries (see **Exhibit 10**).

EXHIBIT 10 Percentage Increase in CLV by Industry When the Churn Rate Is Reduced by 5%



Source: Reprinted from "Zero Defections: Quality Comes to Services" by Frederick F. Reichheld, and W. Earl Sasser, Jr., *Harvard Business Review* 68, September 1990. Copyright © 1990 by the Harvard Business School Publishing Corporation; all rights reserved.

Given the importance of customer retention, how can organizations prevent defection? Three key actions can help: diagnose the reasons for defection, design an early detection system to predict defection, and create programs to target defectors.

Diagnose the Reasons for Defection

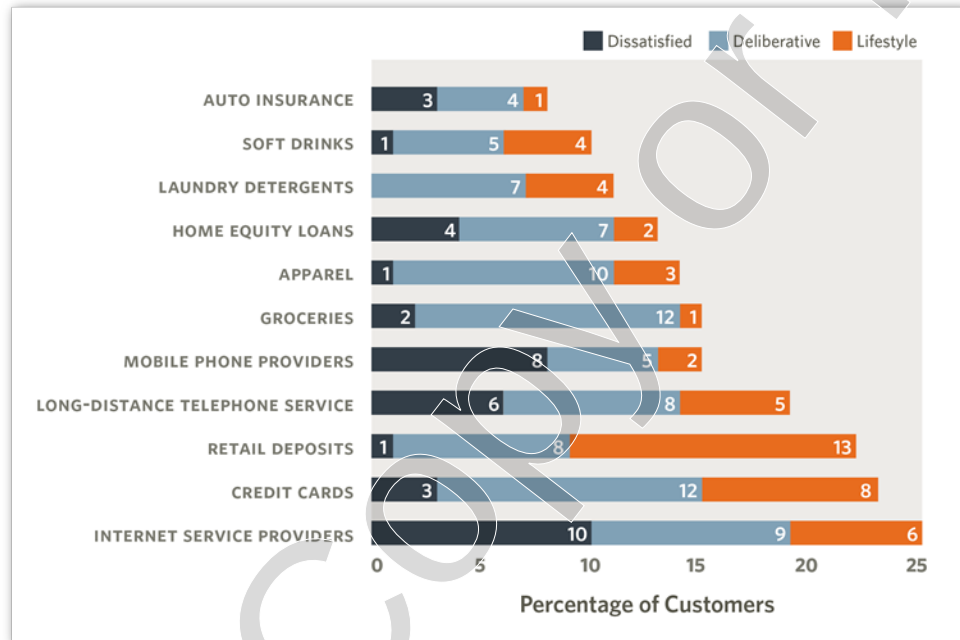
The main reason for customer defection varies by situation. Some factors leading to customer defection are harder to influence than others. A 2002 report from McKinsey & Company traced customer defection to three main causes:¹⁵

- Dissatisfied switchers leave because of poor experience with the company.
- Deliberative switchers leave because of better options elsewhere.
- Lifestyle switchers leave because of external reasons, such as moving out of the area of their utility company, or outgrowing their initial need, such as when their baby no longer needs diapers.

Exhibit 11 shows the split of customer defection types across different industries. In certain industries, such as retail deposits (checking and savings accounts in retail banking), most customer defection arises from customer

lifestyle changes, such as moving out of a bank's geographic region, so attempts to prevent it will have little impact. Addressing lifestyle switchers can be expensive because it involves dramatically changing the product offering or geographic markets. In groceries and apparel, deliberative switchers dominate customer defection, reflecting a highly competitive environment.

EXHIBIT 11 Reasons for Customer Defection*



*Note: Customers who did not defect are not depicted in the graph and make up the remaining percentage of customers.

Source: Adapted exhibit from "Customer Retention Is Not Enough," May 2002, McKinsey & Company.

Design an Early Detection System to Predict Defectors

A detection system is a forward-looking program to predict which customers are likely to defect in the future. Organizations can then take action to address these customers' needs.

McKinsey examined an auto insurance company and identified triggers that were associated with a high likelihood of churn. For example, when a policy is up for renewal, a customer might review options between the company and its competitors, as well as evaluate satisfaction with past contacts with the company. Also, if the customer interacted with the firm to submit a claim or make changes to his or her policy, the customer could decide to cancel as well.¹⁶ Models such as logistic regression can help evaluate which trigger events can predict churn.

Create Programs to Target Defectors

Organizations often use short-term incentives to encourage customers to stay. If you call a credit card company to cancel a card, for example, it may offer you a perk to keep you. While these short-term measures are helpful, managers also need to identify the deep-rooted problems and address them. This may involve retraining employees, redesigning their compensation system, simplifying consumer choices, or improving customer service.

Customer satisfaction programs can have a big impact on retention. After conducting a study to identify key drivers of customer loyalty,¹⁷ a large retail bank changed its services to improve the customer experience, and it mobilized employees with on-the-job coaching and mentoring. After three years, customer loyalty scores increased by 33% and reached the top quartile in the industry. Customer attrition fell by 60%, and results from deepening the customer relationship with auxiliary products improved. Other programs, such as those targeting net promoter score (NPS), can also improve customer management efforts. (See the sidebar “Net Promoter Score.”)

Net Promoter Score

Net promoter score (NPS) is a method to diagnose customer sentiment that goes beyond traditional measures. Unlike customer satisfaction, which stops at how the customer feels about the service or product, NPS also allows organizations to learn the extent to which the customer is willing to spread positive word of mouth about the company.

To measure NPS, a company starts by surveying a sample of its customer base with the following question:

“On a scale of 0 to 10, how likely are you to recommend our company?”

Respondents fall into three groups:

- **Detractors (0–6)** are unhappy with the company. Not only will they likely defect, but they also might spread negative word of mouth. If the company cannot improve the relationship in a way that makes economic sense, it should not acquire these kinds of customers in the future.
- **Passives (7–8)** are neither enthusiastic about nor dismayed with the company. They might stay in the short term, but they could defect to a competitor in the future.

(continued)

(continued)

- **Promoters (9–10)** are delighted with the company and loyal to its products and services. They also spread positive word of mouth, encouraging their friends to use the company.

NPS is calculated by subtracting the percentage of detractors from the percentage of promoters. Dell Inc., for example, uses its NPS number to indicate customer profitability. Specifically, it found that passives were worth about \$118 in profit, detractors cost the company \$57, and promoters each generated \$328 through word of mouth.¹⁸ Other companies go beyond simply monitoring NPS to link it with employee compensation. For example, the UK mobile phone retailer Phones4U links salespeople's compensation to NPS.

Studies suggest that 12 points of NPS led to a doubling of company growth rate.¹⁹ Other studies are more skeptical; one found that 7 points of NPS led to only 1% more growth, while another found that NPS performed just as well as customer satisfaction in predicting firm growth.^{20,21} While the link between NPS and firm growth remains tenuous, NPS is still considered a powerful tool to help managers understand their entire customer portfolio. NPS can also help departments other than Marketing understand customer satisfaction more easily.

Loyalty programs, which reward customers who develop long-term relationships with the company, also help retain customers. These programs allow companies to track customer purchase patterns, which the companies can use to target the customers with enhanced service and promotions. Research has found that these programs not only prevent customer attrition but also encourage customers to deepen their relationship with the organization and accelerate their purchases.²²

2.5 Customer Development

Once a customer has been acquired and retained, a company can increase customer profitability by deepening the relationship. As a rule, it costs eight to ten times more to acquire a new customer than to sell additional products and services to an existing customer.²³ Customer development is especially important when there is intense competition among companies and when customer acquisition costs are high. Three main concepts help organizations garner growth from existing customers: share of wallet, cross-selling and upselling, and redefining the business.

Share of Wallet

Imagine that you have a credit card from the Chase Bank. The bank tracks your purchases and evaluates your lifetime value to determine how much investment it wants to make in you compared with other customers. Using its internal database of purchase transactions, the bank may infer that your CLV is the same as the CLV of another customer—let's call him Bob. But are you and Bob really equally valuable to the bank?

The bank's transaction data is missing one important element to answer this question: competition. Most customers carry multiple credit cards in their wallets and therefore have different potential values. You may spend \$10,000 per year on credit cards but use your Chase credit card for only \$1,000 per year of purchases. Bob may also spend \$1,000 per year on the Chase card, but perhaps he spends only \$2,000 per year on all cards, including the Chase card. This additional information shows that Chase has only 10% of your *share of wallet* while it has 50% of Bob's share of wallet. So even if Bob and you spend the same amount of money with the bank, your upside potential is much higher.

Estimating customers' share of wallet is challenging. Companies rarely know how much their customers spend with competitors. Some industries have third-party data vendors who collect information from various companies and aggregate it into industry-level reports. This provides a high-level view of competition, but it does not give insight into each individual customer's wallet share. One possible way to estimate wallet share is to conduct a survey with a small sample of your customers to get information on their share of wallet; then you can use this information to deduce share of wallet for your entire customer database by using sophisticated models.²⁴

Cross-Selling and Upselling

Once organizations identify customers' wallet shares, they can better target their marketing strategies through cross-selling or upselling campaigns—something in which more than 90% of US and European firms surveyed engage.²⁵ Cross-selling entails selling other products of the company to an existing customer (e.g., selling home insurance to a life insurance customer), while upselling involves selling a premium product to a nonpremium product customer (e.g., selling a \$300,000 life insurance policy to a customer who wanted a \$200,000 life insurance policy).

Upselling raises sales margins, while cross-selling has the additional benefit of reducing customers' switching and thus improving their retention rates. For example, if you have phone service with AT&T, you can fairly easily cancel and switch to another provider, such as Comcast. But if you have signed up for a package that includes telephone, cable TV, and Internet with one company, there

is almost always a switching cost involved. Indeed, a survey found that 40% of consumers said that having bundled high-speed Internet, cable TV, and telephone was the reason they did not switch carriers.²⁶

The impact of cross-selling can be large. Retail banks often offer products to customers to expand their use of deposits and loan products as they grow into financial maturity. Customers at the top-performing bank buy 25% more products than customers at an underperforming bank.²⁷ Another study on a retail bank found that cross-selling the right product to the right customer at the right time could improve the bank's long-term profits by 177%.²⁸

As firms gather more and more customer data, they can better anticipate their customer needs, which can help them in cross-selling and upselling. Tesco, a UK supermarket chain, analyzes customer purchases and mails out coupons for related products. Customers who buy diapers for the first time receive coupons for baby food and beer (evidently fathers who buy diapers also buy beer!). This strategy helped Tesco achieve coupon redemption rates of 8% to 14%, far higher than the industry average of 1% to 2%.²⁹ Similarly, Amazon and Netflix use recommendation systems to help customers navigate their inventory as well as discover new products or films.

Of course, customers who are unprofitable to begin with could amplify their unprofitability if they get cross-sold into even more products and services. A catalog retailer engaged in a cross-selling campaign saw average purchases increase by 44%. But a closer look at specific customer segments revealed that one particular loss-making segment more than doubled its average loss per customer, resulting in an additional loss of \$41 million.³⁰ Rather than cross-selling to the entire customer base, the company would be better off if it targeted cross-selling efforts only to the right customers.

Redefining the Business

A third way that organizations foster growth is by expanding into adjacent categories to deepen their relationship with their existing customers. Several years ago, U-Haul recognized that the rental truck market was becoming very competitive and its margins were getting squeezed. The company also realized that customers who rented trucks needed packing supplies and were generally less price-sensitive about them. As a result, U-Haul decided to stock packing supplies that not only provided added service and convenience to its customers but also improved U-Haul's margins.³¹ Car companies got into auto financing for a similar reason. At the end of 2012, GM Financial accounted for almost 7% of General Motor's total earnings before tax.³² In the airline industry, American Airlines created the Sabre reservation system, a spin-off worth more than the

airline itself. Later Sabre created a new business in the online travel category by launching Travelocity.³³

2.6 Customer Equity

Customer metrics such as CLV are relevant not just to marketing departments. Because cost reduction and investment decisions affect customer value, organizations also use customer metrics to inform financial and strategic decisions.³⁴ Perhaps that is why CFOs and senior executives are also paying more attention to customer metrics to drive company value. For example, the former CFO and subsequent CEO of Rackspace, Lanham Napier, organized a number of customer-focused initiatives and reduced customer churn by one-third. And the finance group at Philips, the global conglomerate, regularly benchmarks its customer metrics against competitor peers in relevant sectors.

As important as CLV is to customer management, recall that it is a metric applicable to the individual customer level only. Customer equity, on the other hand, is a firm-level metric that summarizes the entire customer base. It represents the total CLV across all existing and future customers.^f Because customers are the source of profit for a company, customer equity is a good proxy for company value. During the first dot-com bubble in the late 1990s, when it was hard to estimate the value of Internet companies, researchers used customer equity to assess the value of several companies and found a fair approximation for some, but not all, of them (see **Exhibit 12**).³⁵ Customer equity gave the poorest estimate for successful companies such as Amazon and eBay, partly because they grew at an accelerated pace that outstripped the growth assumptions in the model. Later studies adapted this approach to confirm the close relationship between customer equity and analysts' estimates of firm value (see **Exhibit 13**).

^f Future customers can be predicted based on the current growth rate of the company, the competitive environment, and the company's customer acquisition investments.

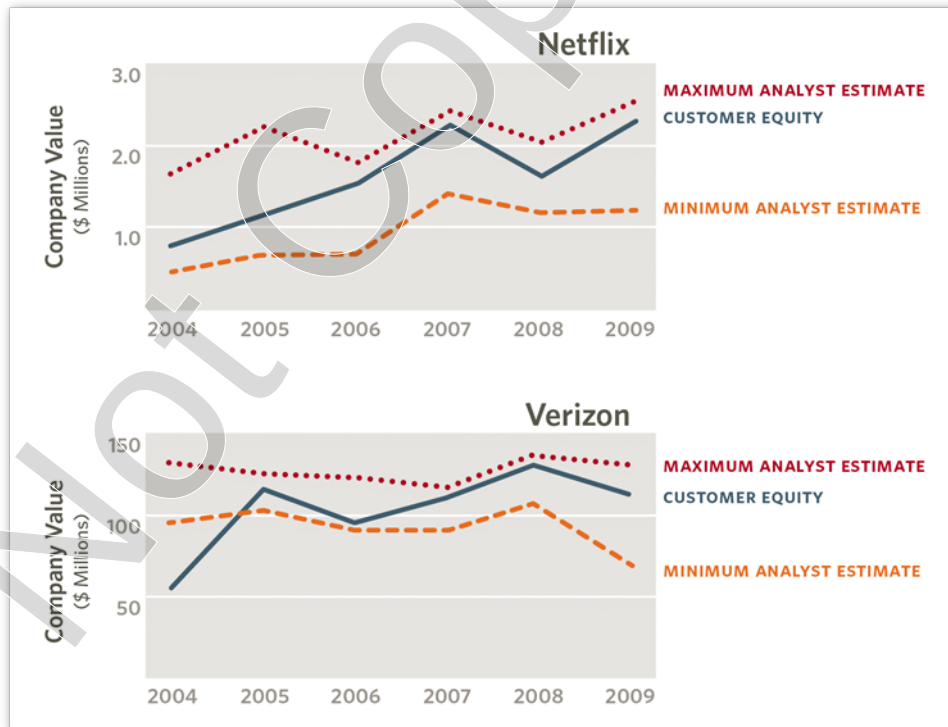
EXHIBIT 12 Customer and Firm Value*



* Market value data and customer value estimated from 2001.

Source: Sunil Gupta, Donald R. Lehmann, and Jennifer Ames Stuart, "Valuing Customers," *Journal of Marketing Research* 41 (Feb. 2004): 7–18. Reprinted by permission.

EXHIBIT 13 Customer Equity and Analysts' Estimates



Source: Republished with permission of *Journal of Marketing*, from "Linking Customer and Financial Metrics to Shareholder Value: The Leverage Effect in Customer-Based Valuation," Christian Schulze, Bernd Skiera, and Thorsten Wiesel, vol. 76, no. 2 (2012); permissions conveyed through Copyright Clearance Center, Inc.

Because customer equity indicates an organization's long-term value, it can also guide marketing investment decisions that maximize shareholder value. One

study for Wachovia Bank, for instance, showed that the marketing budget allocation across various channels, when based on maximizing customer equity, was significantly different than allocations when maximizing new customer acquisitions.³⁶

2.7 Implications for Organizational Structure

Organizations seeking to understand their customers' lifetime value may need to find new ways to coordinate cooperation across departments, and they may even need to restructure how the organization functions altogether. To be sure, measuring CLV and its drivers requires a holistic view of each customer, which poses a challenge for companies organized around products or brands. For example, banks have a division that handles checking and savings accounts, another that deals with credit cards, a third that handles mortgages, and yet another that specializes in investments and brokerage accounts. Although this structure allows employees with specialized knowledge about various products and services to attend to customer needs, it does not provide a complete customer view to understand a single customer in the system.

An organization structured around products cannot provide a complete picture of its customers, who may be dealing with different parts of the company. **Exhibit 14** shows the CLV of three customers across two products of a bank. Customer 1 uses only Product 1, and his CLV for this product is \$500; Customer 2 uses only Product 2, with a CLV of \$500. But Customer 3 uses both Products 1 and 2, with a CLV of \$300 and \$400, respectively, for the two products. If the firm has resources to focus on only one customer, which one should it invest in? Although Customer 3 is the most profitable for the firm, a product management structure looking only within each column would give the wrong incentive for the first product manager to invest in Customer 1 and the second product manager to invest in Customer 2. That is why providing a complete customer view enables companies to measure the correct CLV for each customer that may span several product lines.

EXHIBIT 14 Organization Structured Around Products Versus Customers

	Product 1	Product 2
Customer 1	\$500	\$0
Customer 2	\$0	\$500
Customer 3	\$300	\$400

Source: Gupta, Sunil; Lehmann, Donald, *Managing Customers as Investments: The Strategic Value of Customers in the Long Run* (Paperback), 1st, © 2005. Printed and Electronically reproduced by permission of Pearson Education, Inc., Upper Saddle River, New Jersey.

2.8 Conclusion

Customer management requires organizations to assess two sides of customer value—the value organizations provide *to* customers and the value they derive *from* customers. This framework is captured by customer lifetime value, which provides an estimate of the present value of all future profits generated by each customer over her time of business with the firm. Three factors influence CLV: customer acquisition, customer retention, and customer development. A manager can affect CLV by implementing marketing efforts targeted at each of these drivers.

At a macro level, customer equity—the total CLV of current and future customers—provides a good proxy for overall firm value. Measuring CLV and implementing customer management programs also suggests a different organizational structure: a complete customer view rather than a product-centric approach.

However, customer management does not work uniformly across all industries. Certain environments where customers are identifiable and engage with the company over time allow for better forecasting and interventions. In industries such as telecoms and banking, customer management is more developed. Other industries may gain less from customer management, as discussed in this reading. For example, in oil refining, customers play a smaller role than technology and operations management.

Despite the fact that customer management has far-reaching implications for marketing and operational practices for firms in many industries, customer management does not exist in a vacuum. Brand perceptions, segmentation, decisions about promotions and pricing, and other marketing strategies can all influence the effectiveness of customer acquisition, retention, and development efforts.

3 SUPPLEMENTAL READING

Customer lifetime value looks at cash flows associated with an individual customer independent of other customers, but in reality, customer decisions are interdependent because of the social interaction involved. These social interactions could be direct, such as referrals, or indirect, as in the case of network effects. They could involve friends through word of mouth or strangers via social media. In this section we will discuss the direct impact of referrals, the indirect network effects of so-called free customers, and the impact of social influence within networks.

3.1 Customer Referral Value (CRV)

Two customers may have the same CLV but represent different value to the company if they have a different impact through word of mouth. One study polled 9,900 customers of a telecom firm to find out their referral intentions and then tracked their behavior and the behavior of the prospective customers brought in through referral. It then estimated the CLV of these customers as well as their **customer referral value (CRV)**, or the total value of their referrals. It concluded that the most valuable customers based on CLV were not the ones responsible for the most referrals (**Exhibit 15**). Those who made the most valuable referrals were customers close to the median CLV.³⁷ In Exhibit 15 you can see that the top 10% of customers, ranked by CLV, had an average CRV of only \$40.

Customers with both high CLV and CRV are most valuable, so organizations should target their investment at retaining those customers. Customers with high CLV but low CRV should be encouraged to make more referrals. Conversely, those with high CRV but low CLV can be targeted for customer development strategies to increase wallet share.

EXHIBIT 15 Customer Referral Value for Customer Lifetime Value Deciles

Customers Ranked by CLV <i>Decile, highest to lowest</i>		Customer Lifetime Value	Customer Referral Value*
	1	\$1,933	\$40
	2	1,067	52
	3	633	90
	4	360	750
	5	313	930
	6	230	1,020
	7	190	870
	8	160	96
	9	137	65
	10	120	46

*Customer Referral Value equals average for each decile after one year.

Source: Reprinted from "How Valuable Is Word of Mouth?" by Viswanathan Kumar, J. Andrew Petersen, and Robert P. Leone, *Harvard Business Review* 85, October 2007. Copyright © 2007 by the Harvard Business School Publishing Corporation; all rights reserved.

One way to encourage referrals is to provide incentives to customers. A study examined the effectiveness of this strategy by monitoring the behavior of 10,000 accounts of a German bank that gave its customers a €25 reward if they referred a new customer. The study found that, on average, referred customers were 18% more likely to stay with the bank, and furthermore, they generated 16% more profit than the nonreferred customers did. This translated into a return of approximately 60% on the €25 referral reward offered by the bank.³⁸

3.2 Value of a Free Customer

Many businesses have two-sided markets, where one side pays but the other side receives goods or services for free. For example, sellers pay eBay a listing and per-item sales commission fee, but eBay does not charge its buyers any fees. Similarly, job seekers can post their résumés for free on Monster or LinkedIn, but corporate recruiters pay a service fee to obtain résumés from these companies.

One might reasonably ask, "What is the value of a free customer, such as a buyer at eBay or a job seeker at Monster?" Traditional CLV does not provide an answer to this question because these free customers do not pay anything directly to the firm. In fact, the firm incurs a cost to host these customers on its site, so their traditional CLV is negative. Yet intuition tells us that the free customers are important for the survival of these platforms—without buyers, there are no sellers, and without job seekers, no recruiters will come to the website. In other words, these platforms exhibit **indirect network effects**, which

exist when an increase in the size or usage of a product (e.g., video game consoles) expands the range of complementary products (e.g., video games), which in turn increases the value and usage of the original product. In the eBay and Monster examples, having more buyers encourages more sellers to come online, and vice versa. Therefore, the value of a free buyer to the firm comes from these indirect network effects, because these buyers bring in more paying sellers.

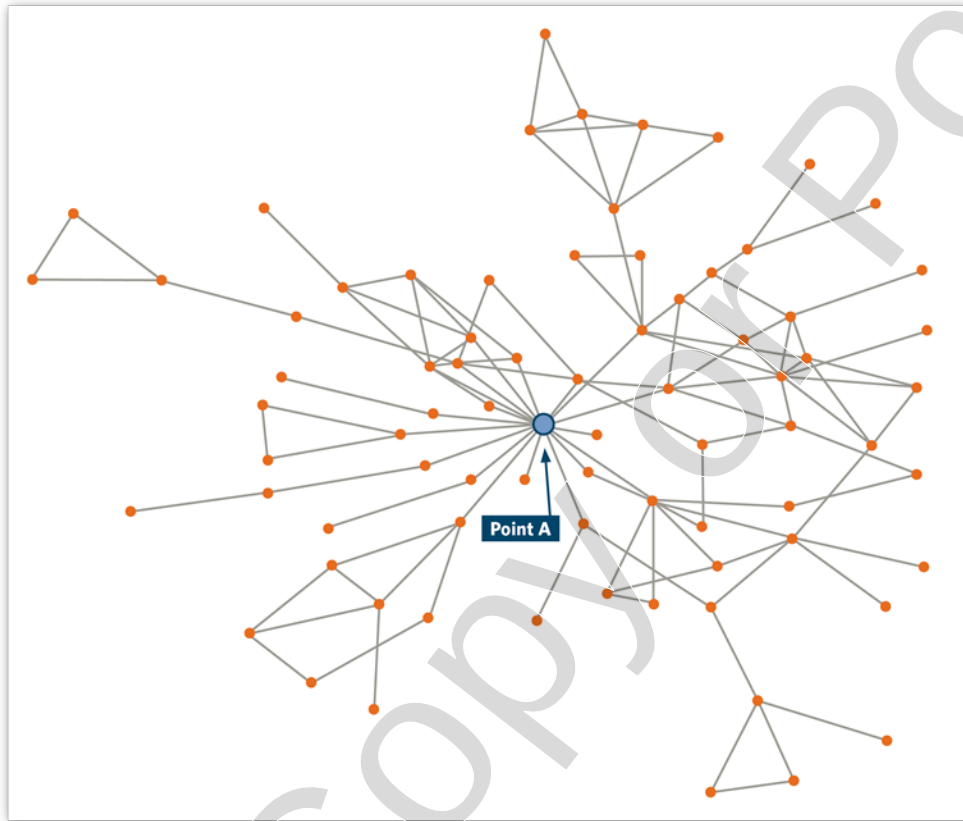
Researchers have built a model to quantify these indirect network effects. Using data from a US auction house, they found that free buyers were almost as valuable as the paying sellers.^{39,40} Others adapted this approach for a European auction platform and found that acquiring a new buyer would cost the firm less than €25, but it would bring in more than €94 in commissions in the long run through the indirect network effects.⁴¹

3.3 Social Influence

Our friends influence our purchase behavior—whether it is for music, an iPad, or clothes. In the age of online social networks, it is even easier for people to share information with their friends. Consider a sample network of the Korean social networking site Cyworld (see **Exhibit 16**). The person in the middle of this network (labeled Point A) is well connected to many people around him. Even if this person does not buy much from the company and has low CLV, he may still be highly valuable to the firm, due to the potential influence he may exert on his friends.

Research has shown that adoption of an instant messenger app by a consumer is nine times as likely if someone in this consumer's network had already adopted this app. Adoption is fifteen times as likely if two people in the consumer's network had adopted the app.⁴² In other products, adoption probability increased by three to five times due to social influence.⁴³ Social influence can also affect customer retention. A study of cell phone customers found that a customer's risk of cancellation increased by 80% if one of his or her friends had canceled the service recently.⁴⁴

EXHIBIT 16 Sample Network of Cyworld Users



Source: Reprinted from Harvard Business School, "CyWorld: Creating and Capturing Value in a Social Network," HBS No. 509-012 by Sunil Gupta and Sangman Han. Copyright © 2008 by the President and Fellows of Harvard College. Reprinted by permission.

Measuring social influence is tricky because it is usually hard to separate this effect from **homophily**, or the idea that people who are similar are more likely to know each other in a social network. If you and your Facebook friend buy the same product, it may simply reflect that both of you have similar preferences, rather than any kind of social influence. Another example: an influential study found that obesity might be contagious: If a friend became obese, a person had 171% increased likelihood of becoming obese as well.⁴⁵ Similar results were found for smoking cessation, happiness, and loneliness.^{46,47,48} Other researchers questioned these results, however, suggesting that friends in the study shared common interests and were subject to similar environments. In other words, similar tastes that made these people friends in the first place were responsible for the results, not social influence. The distinction between homophily and social influence, therefore, remains an active area of research in the social sciences.

4 KEY TERMS

cohort A group of customers acquired within the same time frame.

customer churn rate One hundred percent (100%) minus the customer retention percentage rate.

customer equity The total customer lifetime value (CLV) of current and future expected customers.

customer lifetime value (CLV)

The expected value of a customer, consisting of future contribution (revenue less direct and attributable costs) and taking into account that the customer could leave in the future (via retention rate) and time value of money (via discount rate).

customer referral value (CRV)

The expected value of referrals by a customer.

discounted cash flow Valuing an asset using the time value of money.

homophily The idea that people who are similar to one another are more likely to know each other in a social network.

indirect network effects Effects that exist when an increase in the size or usage of a product (e.g., video game consoles) expands the range of complementary products (e.g., video games), which in turn increases the value and usage of the original product.

net promoter score (NPS) A method to assess customer portfolio health by asking existing customers whether they will be likely to recommend your brand, on a scale of 0 to 10. NPS is calculated as the difference between the percentage of detractors (those who responded 0–6 on the scale) and promoters (those who responded 9 or 10). Passives are those who responded 7 or 8.

weighted average cost of capital Financial measure of the cost of capital for a company; a weighted average of cost of loans and equity.

5 FOR FURTHER READING

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